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ECONOMIC OUTLOOK

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TAX REFORM SHOULD PROMOTE ECONOMIC GROWTH

by
Richard W. Rahn

One of the great tragedies of our time is that so few people seem to understand how economic growth occurs and, as a result, fail to fully appreciate the great benefits of rapid economic growth. This is apparent in much of the current debate about tax reform. Specifically, many politicians, commentators and self-styled "citizen advocates" are demanding large increases in corporate taxes and the institution of increased individual and corporate "minimum taxes." However, there is little, if any, discussion of how such proposals are likely to affect economic growth. Many of those who advocate tax increases suffer from acute economic ignorance. Others, and unfortunately, all too many, engage in sheer demagoguery for their own political purposes. When an economy enjoys high levels of economic growth, almost everyone benefits, particularly the poor. Higher levels of growth result in the creation of new job opportunities, raise the nation's standard of living, and reduce the poverty rate. It also increases the funds available for spending on social services, such as medical care and education.

We need to, and indeed ought to, pursue tax reform, but tax reform to make the world better, not to punish the productive. The Administration and other advocates of tax reform have said that its goal should be to promote economic growth, and simplify the tax code, while at the same time, being equitable. The relative degree to which alternative tax reform proposals promote economic growth can be projected with reasonable certainty given the current level of economic knowledge. Simplicity is a somewhat more elusive goal, but most people can judge whether a given proposal is likely to reduce or increase the number of manhours required to comply with it.

Equity is a more difficult concept since it is so laden with value judgments. But, in general, most people would agree that any reform of the tax code should result in people of like circumstances paying similar levels of tax. Moreover, lower income individuals should not pay a higher percentage of their income in taxes than do higher income individuals.

These three goals of tax reform do not have to be in conflict, and in fact, any correctly designed tax reform proposal will advance all of them simultaneously. However, the wrong kind of tax reform could slow economic growth or even throw the economy into a recession. Only tax reform that reduces tax rates without increasing the tax bias against savings and investment is unambiguously pro-growth.

Reduced tax rates will augment economic growth in three ways. First, because lower tax rates increase individuals' after-tax wages on additional work, people tend to work more. The supply of labor will increase as more people work overtime, they take second jobs, spouses enter the work force for the first time, and so on. Second, because lower tax rates increase the after-tax return on savings and investment, people tend to save and invest more. This provides the capital necessary to build additional factories or buy more or better machinery. Third, by reducing the value of various tax breaks, lower tax rates will reduce the tax-induced economic distortions that have made the economy less efficient and productive. The phased-in tax rate reduction enacted in 1981 had precisely these effects.

Currently, personal income tax rates range from 11 percent to 50 percent, while corporate income over $100,000 is taxed at a 46 percent rate. The Administration's Tax Reform plan would reduce individual tax rates to 15 percent, 25 percent, and 35 percent. Compared to the other major tax reform proposals, the Administration's plan contains the highest individual tax rates. In contrast, the Bradley-Gephardt "Fair Tax Act" has rates of 14 percent,

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26 percent, and 30 percent, while the Kemp-Kasten "Fair and Simple Tax" (FAST) has tax rates of 19 percent and 29 percent. Corporate tax rates would be reduced to 30 percent under the Bradley-Gephardt plan, 33 percent under the Administration's plan, and 35 percent under the Kemp-Kasten plan. The Kemp-Kasten and Administration plans retain lower tax rates for small corporations.

Unfortunately, many tax reform plans reduce tax rates at the expense of increasing the tax bias against savings and investment. As a result, these plans will reduce the amount of investment in job-providing plants and productivity-improving equipment. Consequently, they are likely to slow the rate of economic growth. The people that would be most hurt by the resulting stagnation of the economy are the working poor. They also stand to gain the most from a dynamic, growing economy with high employment and an increasing standard of living. There are three critical factors that must be weighed to determine whether a plan has a constructive, pro-growth treatment of savings and investment.

First, the plan must have adequate capital cost recovery or depreciation allowances. Until the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the tax law discriminated against capital investment. Capital expenses incurred in a given year had to be deducted over a dozen or more years even though virtually all other business expenses were deductible in the year incurred. An unbiased tax code would allow capital expenses to be deducted in the first year just like other business expenses. The Accelerated Cost Recovery System (ACRS), enacted under ERTA, dramatically simplified the tax treatment of capital investment and shortened the period over which capital expenses were deducted. In combination with the investment tax credit, ACRS has approximately the same economic effect of simply deducting the capital expense in the year incurred (often called first-year expensing). This dramatic move toward tax neutrality has caused investment to boom. So far, in the recovery, investment has grown twice as quickly as average and at a stronger rate than any recovery since World War II. The Kemp-Kasten proposal achieves approximate economic neutrality with its Neutral Cost Recovery System (NCRS), which is designed to provide the equivalent of first-year expensing. The Administration and Bradley-Gephardt plans, however, would return to systems worse than those existing prior to 1981. Because they would dramatically increase the cost of capital, investment would fall and economic growth would slow down.

Second, no constructive reform plan should increase the tax rate on capital gains. In 1978 and 1981, the capital gains tax rate was reduced. Following both tax rate reductions, the government received more tax revenues from the capital gains tax. Moreover, new issues of securities increased dramatically, investment in entrepreneurial activity skyrocketed, and markets became more efficient. Because of this increased taxable economic activity and a reduced tax disincentive to realize capital gains, the government actually profited greatly from lower tax rates. More importantly, however, the American people had more opportunities and a higher standard of living (see *Boosting Capital Formation and Tax Revenues: The Case of Capital Gains Tax Rate Reduction,* in this issue). The Bradley-Gephardt plan would raise the capital gains tax rate dramatically, while Kemp-Kasten and the Administration plans would reduce it.

Third, constructive tax reform plans should build on the Individual Retirement Account (IRA) concept. Money placed in IRAs is deducted from taxable income and taxed only upon withdrawal. IRAs virtually eliminate the tax bias against selected savings. The Administration plan would raise the contribution of a nonworking spouse to $2,000 from the current $250.

Only the Kemp-Kasten FAST plan is unambiguously pro-growth. The inadequate capital cost recovery allowances in Bradley-Gephardt and the Administration plans threaten to undo all of the other positive aspects of those plans. The Congress, in considering tax reform, should ensure that damaging capital cost recovery provisions and capital gains taxation do not make it through the policy process into law.

Fundamental tax reform could cause economic growth of unequalled strength in this country. But we must ensure that in an attempt to be "fair", we do not misguidedly adopt a tax reform plan that will cause economic reverses that most harm the least advantaged members of our society.

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ECONOMY FLASHES MIXED SIGNALS

by
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At first glance, the news that the nation's gross national product increased at an annual rate of 0.7 percent in the first quarter, slower than the preliminary estimate of 1.3 percent, was surprising. The figure revived unfounded fears that the economy might be stumbling into a "growth recession," as Federal Reserve Vice-Chairman Preston Martin called it.

Economic data, however, continue to provide mixed signals which lend themselves to a different interpreta-

tion of the economy's health as well as to future prospects. Downward revisions to business investment, government purchases, and net exports outweighed higher estimates of consumer spending and residential investment during the first quarter. It is interesting to note that, since the third quarter of last year, swings in real inventories have largely offset swings in net exports, suggesting that while domestic demand remains strong, much of it is being satisfied by imports. Reflecting the economy's current strength, consumer spending grew at a strong 5.2 percent annual rate during the past quarter, while new housing starts increased by 47.8 percent. The improvement in housing continued in April as starts reached 1.9 million units, their highest level in nearly a year. On the other hand, growth of business fixed investment continued to slow in the first quarter, posting a 2.6 percent annual rate of increase, the smallest since the first quarter of 1983. These divergent trends have caused some confusion regarding the overall direction of the economy. Although that direction may be obscured temporarily by factors such as the strong dollar and the prospects for tax reform, the stage is being set for a rebound in domestic production.

In particular, recent action by both the House and Senate on a package of budget reductions which is likely to be enacted before summer's end, will go a long way towards resolving the deficit problem without resorting to counterproductive tax increases. At the same time, there is reason to believe that once the spending cuts are enacted, the Federal Reserve, in keeping with previous pronouncements by Chairman Volcker, will move to ease monetary policy further. In fact, the Federal Reserve has already cut the discount rate, from 8 percent to 7.5 percent, bringing it to the lowest level since August 1978. In addition, after remaining unchanged for four months at 10.5 percent, the prime rate, as expected, fell to 10 percent in May. Further decline in the prime rate, to single digit levels, is anticipated to occur within weeks. As a result of these policy changes, both residential and nonresidential investment are expected to rebound by mid-year. By the end of 1985, new housing starts should reach the two million unit level. Business fixed investment could rise by 15.5 percent by the end of 1986.

Consumer spending will also contribute to second quarter strength. Delayed payment of tax refunds during the first quarter mean larger than normal refunds during the second quarter. While the resulting increase in disposable income will most likely be saved, some increase in consumer expenditures should also occur. Therefore, the outlook for consumer purchases, including autos, remains relatively strong as consumer optimism is bouyed by recent declines in interest rates and continued employment gains. Indeed, retail sales have recovered from their March slump and are now nearly 5 percent higher than their year-ago level. Further, domestic auto sales surged in mid-May reaching an 8.9 million unit annual rate. To keep up with expected strong demand, domestic car manufacturers' second quarter production plans call for the highest output levels since 1977-78.

While the trade situation may continue to deteriorate this quarter, the deficit is not likely to widen as rapidly as it did during the first quarter. Since it is the rate of change in the trade deficit, not its size, that influences the GNP figures, this bodes well for measured GNP during the second quarter. However, for the year as a whole, net exports will remain a major drag. Even though we expect a steady decline in the exchange value of the dollar, its effect on imports will not be felt immediately. Initially, foreign suppliers are expected to be successful in protecting their market shares by resisting dollar price increases. However, if the decline in the dollar's value accelerates, then import price increases will become more evident. As a result, import volumes may decline, but total dollars spent on imports may not. In sum, imports are expected to remain strong throughout the remainder of this year, rising by 8.3 percent. On the other hand, the expected decline in the exchange rate will improve the competitiveness of U.S. exports. By 1986, real export growth should outpace real import growth.

Labor market improvements appear to have reached a plateau in recent months, with the civilian unemployment rate remaining at 7.3 percent in May, showing little or no change since August 1984. However, two major employment statistics set new records in March: the civilian employment to population ratio climbed 0.2 percentage points to 60.3 percent, while the participation rate reached 65 percent. The monthly survey of establishments indicates that nonfarm employment rose by 381,000 in March, the largest increase since April 1984.

In sum, given the first quarter's weakness, this month's forecast shows real GNP growing by 3.2 percent in 1985 and 4.2 percent in 1986, on a year-over-year basis. Quarterly growth rates are expected to remain in the neighborhood of 4.5 percent, a very healthy rate for the third year of expansion. The civilian unemployment rate averages 7.2 percent this year and 6.9 percent in 1986. Inflationary pressures remain moderate while interest rates continue to edge downwards.

As mentioned, the major threat to the current expansion stems from the continued deterioration of the trade balance and the growing protectionist sentiment in this country. However, fiscal policy risks also loom heavily on the horizon. While progress in reducing federal spending is encouraging and, once enacted, should prove to be very beneficial to the overall economy, uncertainty about the final form of the tax package may take the wind out of the expansion. In particular, the enactment of a tax reform plan which does not preserve savings and investment incentives will be very onerous, indeed, as detailed in the previous article.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1983–1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS			
	Actual		Forecast							Actual		Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1983	1984	1985	1986
GROSS NATIONAL PRODUCT													
Real GNP	4.3	0.7	4.4	4.9	3.4	4.9	4.3	3.8	3.0	3.7	6.8	3.2	4.2
Consumption	3.6	5.2	3.4	4.1	4.5	3.6	3.7	3.3	3.4	4.8	5.3	4.0	3.8
Residential Investment	-5.9	1.4	14.7	27.2	14.4	5.9	7.1	-4.6	-8.0	41.7	12.2	5.4	8.2
Business Fixed Investment	8.5	2.6	5.8	9.6	10.0	8.7	7.3	8.5	10.1	2.5	19.8	8.0	8.7
Equipment	5.4	-2.5	5.5	9.3	10.2	9.7	8.3	10.1	11.5	7.3	21.5	6.6	9.4
Structures	17.2	16.8	6.8	10.1	9.3	6.1	4.7	4.5	6.5	-7.8	15.6	11.9	6.8
Exports	-0.8	-6.1	6.1	7.7	9.3	8.7	8.2	8.6	11.3	-5.6	4.7	1.8	8.6
Imports	-28.3	31.3	0.3	9.2	5.7	7.6	6.0	6.4	5.7	7.6	27.0	8.3	6.4
Government Purchases	5.9	-1.8	6.8	3.1	-9.5	3.7	2.8	2.7	-4.7	-0.3	3.5	3.4	0.4
Inventory Change ($B)	37	41	33	33	38	44	45	46	49	-13	58	36	46
New Car Sales (mil. units)	10.4	10.8	10.9	10.9	11.1	11.2	11.4	11.5	11.5	9.2	10.4	10.9	11.4
Housing Starts (mil. units)	1.6	1.8	1.9	1.9	2.0	2.0	2.0	1.9	1.9	1.7	1.8	1.9	1.9
EMPLOYMENT, WAGES AND PRICES													
Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.1	7.1	7.0	6.9	6.9	9.6	7.5	7.2	6.9
Compensation	3.6	5.5	4.3	4.3	4.1	6.0	4.9	5.1	5.2	4.8	4.2	4.3	4.9
Productivity	2.3	-2.5	3.6	2.4	3.1	2.5	2.2	2.6	2.6	3.4	2.7	1.1	2.5
Unit Labor Costs	1.3	8.1	0.7	1.9	0.9	3.4	2.7	2.4	2.6	1.3	1.4	3.2	2.3
Consumer Prices	3.5	3.3	4.3	3.1	3.3	3.7	3.6	3.6	3.6	3.2	4.3	3.6	3.6
GNP Deflator	2.8	5.6	2.6	2.8	3.3	3.5	3.3	3.2	3.8	3.8	3.8	3.7	3.3
Prime Interest Rate (%)	11.8	10.5	10.1	9.5	9.3	9.2	8.7	8.4	8.8	10.8	12.0	9.9	8.8
Profits from Current Production ($B)*	203.9	209.8	214.3	220.1	228.5	233.7	242.5	245.7	247.1	149.4	195.9	218.2	242.3
GOVERNMENT FISCAL POLICY ($BILLION)**													
Unified Budget–Receipts										601	666	740	801
Unified Budget–Outlays										796	842	954	972
Unified Budget–Federal Surplus or Deficit										-195	-176	-214	-171

*Corporate profits after tax with inventory valuation and capital consumption adjustments.
**Unified Budget figures on a fiscal year basis.

SOURCE: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's second revision to the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government spending of $50 billion in 1986. Federal government purchases, on an NIA basis, grow at an average annual rate of 2.5 percent between 1984 and 1986. The nation's money supply, as measured by M(1), rises by 7.9 percent in 1985 and 6.6 percent in 1986. The federal minimum wage remains at $3.35 per hour throughout the forecast horizon. The price of imported crude oil averages $27.28 in 1985 and $26.19 in 1986 compared to $28.87 in 1984 and $29.35 in 1983. The trade-weighted exchange value of the dollar falls by 4.5 percent by the fourth quarter of 1985 compared to the same quarter in 1984. During 1986, it falls by 8.4 percent.

ECONOMIC STAGNATION AND GOVERNMENT GROWTH: SOME NEW EVIDENCE

by
Ronald D. Utt

By all accounts, the writing of the President's address to the European Parliament in May was the subject of a struggle within the White House over how bold the President should be in advising Europe's leaders on matters of economic policy. This struggle, fought between those who would have the President challenge the European leaders to spur growth by policies that relied on free market solutions, limited government and tax relief, and those who would have him limit his remarks to predictable platitudes that would neither inspire nor offend, was won by the diplomats.

It's too bad it turned out this way since, in retrospect, the President had everything to gain and nothing to lose by being forthright in his advocacy of solutions of proven performance. Certainly, the Europeans, heavily taxed and now mired in nearly a decade of economic stagnation, should have been given the opportunity to hear the President out on his vision for the West. Heaven knows, we've suffered often enough from their advice on any number of strictly domestic issues.

Aside from the issue of whether such a speech was impolitic or not, the existence of divergent economic policies among comparably endowed nations offers us unique analytical opportunities to compare national performance under different approaches to government taxing and spending. As this article demonstrates, the low-tax/low-spend countries have outperformed those with large and rapidly growing government sectors. Such an analysis also shows that the lack of fiscal discipline we have experienced is a worldwide phenomenon and that the situation abroad is often worse than our own.

In recent years, many economists and policy analysts have focused on the rising burden of taxation throughout the world, noting distinct differences in economic performance between low-tax and high-tax countries. Generally, the low-tax countries out-performed the others by a wide margin in terms of economic growth and improvements in the standard of living. Seldom, however, have these analysts taken the one step backward to determine the cause of burdensome taxation – rapidly rising government spending which absorbs ever larger shares of a nation's economic output.

One of the first to formally address this destructive trend toward excessive spending and taxing in the major industrial countries was J. de Larosier, Managing Director of the International Monetary Fund. In a 1982 paper titled, *Restoring Fiscal Discipline: A Vital Element of a Policy for Economic Recovery,* Mr. de Larosier placed the blame squarely on the changing attitudes about the role of government and how these changes led to a rapid rise in spending. In turn, this rapid growth in spending forced governments to raise taxes to the point where economic growth and productivity suffered.

Three years later, the fiscal imbalances he observed have only worsened, as have the economies of those countries with the highest taxes. From 1965 to 1980, the ratio of total government spending to gross domestic product (GDP) for the seven major industrial countries rose from 30 percent to 39 percent. Over the same period, the tax share rose from 29 percent to almost 36 percent, with the collective deficit rising accordingly. Two years later, the spending share for the same seven countries

TABLE 1
TOTAL OUTLAYS OF GOVERNMENT AS A PERCENTAGE OF GDP

Country	1965	1980	1982
United States	27.9%	35.0%	37.6%
Japan	20.0	32.4	34.5
Germany	36.7	48.3	49.4
France	38.4	46.4	50.7
United Kingdom	36.4	45.4	47.4
Italy	34.3	46.1	53.7
Canada	29.1	41.0	45.8
Average	30.1	39.3	41.4
Belgium	32.3	51.1	56.6
Denmark	29.9	56.2	60.7
Netherlands	38.7	59.5	63.7
Sweden	36.1	62.1	67.3

Source: Organization for Economic Co-operation and Development

TABLE 2
RECEIPTS (TAXES AND FEES) OF GOVERNMENT AS A PERCENTAGE OF GDP

Country	1965	1980	1982
United States	26.5%	32.0%	32.0%
Japan	19.5	28.0	30.2
Germany	35.7	44.6	45.3
France	38.4	45.5	46.9
United Kingdom	33.4	40.5	43.7
Italy	30.1	37.8	41.5
Canada	28.1	37.1	39.0
Average	28.9	35.6	36.0
Belgium	30.7	43.0	45.4
Denmark	31.2	52.2	50.7
Netherlands	37.3	55.0	55.8
Sweden	39.6	57.1	59.7

Source: Organization for Economic Co-operation and Development

moved above 41 percent while taxes held steady at 36 percent of GDP. Tables 1 and 2 provide details on the changes for these countries, as well as even more dramatic trends in several other industrial nations.

As these two tables clearly illustrate, from a position of near balance in 1965, the government budgets of the leading seven countries slipped further into the red as the years progressed. And while tax burdens moved up sharply as well, they failed to keep pace with government spending, which now exceeds 50 percent of GDP in two of the seven and six of the eleven countries presented above.

When Mr. de Larosier wrote his paper, he could only speculate on the damage this trend might do. Although there were ample signs of economic deterioration at the time, it was difficult to separate this factor from the world recession that characterized 1982, and from the energy price shocks that battered the world economy during much of the 1970s. But with these events now behind us and a world economic recovery underway, we have a much greater sense of the damage that has occurred in those countries, particularly in Europe, at the top end of the tax and spending scale.

At the risk of over-simplification, the process of economic deterioration from excessive growth in government follows a pattern which, in its later stages, becomes nearly involuntary and self-fulfilling. It begins by accepting broader responsibilities for government which, in order to be fulfilled, necessitate an increase in government spending as a share of a country's national income. This leads to greater government budget deficits and/or higher taxes. If central banks print more money in a vain effort to offset the impact of the deficit, then inflation worsens and this further drives up tax receipts as rising nominal incomes confront progressive income tax systems. Either way, the tax burden rises in response to growing expenditures.

At some point, the rising tax burden begins to create a strong disincentive to work, to invest and to engage in entrepreneurial activity which, in turn, contribute to a slowing of economic growth and job creation. Unemployment begins to rise, other social problems emerge and the demand for government services and support increases. Government spending rises further, as do the taxes necessary to fund it, and the process repeats itself, but this time with greater vigor because the worsening economic environment deepens the perceived need for greater government services. It goes on and on like this until there emerges a situation like that of Sweden or the Netherlands where the government accounts for about two-thirds of the economy.

Measures of economic deterioration over time and among countries abound. Perhaps the clearest indication of decay is the dramatic decline in economic growth for the seven major industrial countries since 1965. Table 3 lists the average annual rate of growth in real GDP for these countries at five year intervals beginning in 1965.

TABLE 3
AVERAGE REAL GDP GROWTH
FOR THE SEVEN MAJOR INDUSTRIAL COUNTRIES
1965 TO 1984

Period	Annual Average Real Growth in GDP
1965-69	5.04%
1970-74	3.62
1975-79	3.28
1980-84	1.84

Source: Organization for Economic Co-operation and Development

Among countries, differences in performance over time correspond closely to relative tax and spending burdens, particularly over the past few years when high tax Europe has been slow to recover while Japan, the U.S. and Canada, with lesser tax and spending burdens, have experienced strong business expansions. Indeed, absent the powerful U.S. recovery which has drawn in abundant imports from abroad, the European situation would be even more anemic. Table 4, which ranks industrial production performance for the same seven countries from 1980 to 1984, offers a dramatic illustration of the differences. The figure in parentheses provides the countries' rank within the seven according to the government's share of spending in the economy as measured in Table 1. Note the perfect correspondence between industrial decay and government encroachment.

TABLE 4
INDEXES OF INDUSTRIAL PRODUCTION
1980 = 100

Country	1981	1982	1983	1984
Japan (7)	101.0	101.4	104.9	116.5
United States (6)	102.6	94.2	100.3	111.1
Canada (5)	100.9	90.1	95.5	1038
United Kingdom (4)	96.3	98.0	101.9	102.8
Germany (3)	98.4	95.4	96.2	99.6
France (2)	96.8	95.3	96.5	98.6
Italy (1)	99.8	97.5	91.8	95.2

Source: U.S. Department of Commerce

There is an interesting side note to the above trends as they relate to the current domestic debate about the value of the dollar and its ramifications for U.S. industry. Some of those concerned about the dollar's rise relative to other currencies argue that it is leading to the "deindustrialization" of the United States and the economic benefit of our international competitors. Ironically, as the table illustrates, it is those countries whose currencies have declined the most against the dollar (Italy and France) that are experiencing the severest industrial problems.

Perhaps the clearest difference, at least in human terms, in national performance is the number of jobs created in these countries. Again, as Table 5 shows, the lower tax and spending countries have outperformed the others in creating new employment opportunities. Indeed, several of the high-tax/high-spend countries experienced actual declines in total employment over the past several years.

TABLE 5
INDEX OF EMPLOYMENT
1977 = 100

Country	1980	1982	1984
United States	107.7	108.0	113.9
Canada	110.8	110.2	113.8
Japan	103.5	105.5	107.9
Italy	102.9	103.0	102.7
France	100.2	99.6	98.3
Germany	103.0	100.3	98.3
United Kingdom	100.8	95.4	95.9

Source: U.S. Bureau of Labor Statistics

Since the above table makes no distinction between jobs in the public or private sector, the historical index actually overstates the employment creation performance of many of the European countries. Between 1960 and the present, a period during which all countries gained in total employment, Belgium, the United Kingdom, Italy and Germany all lost jobs in the private sector. In other words, what job growth occurred was accounted for by the government. Recently, even those European countries that did create private sector employment over the last twenty-five years began to experience deterioration during the 1980s which could, in turn, lead to a net loss in private employment within the next several years. In the United States, by contrast, jobs in the private sector expanded by fifty percent over the same period.

Employment growth, or the lack thereof, is one measure of job opportunities. Another is the unemployment rate. Here again, the U.S. is doing well, although international comparisons tend to be distorted by the extent to which government jobs programs maintain "employment" when stagnation occurs. While the U.S. unemployment rate has stabilized at 7.3 percent over the past several months, European unemployment rates have stayed above 10 percent for the last few years. The Netherlands leads the list with 16 percent of the work force unemployed, Italy comes in a close second at 14.2 percent. Belgium weighs in at 14.1 percent and the United Kingdom follows behind at 13 percent, up from 12.5 percent a year ago despite the gradual improvement in its economy.

In the end, what really matters from the point of view of the average citizen is what has happened to his or her standard of living over time. Indeed, if anything distinguishes this century from all of those that have preceded it, it is the rapid gains that have occurred in the material welfare of much of the world's population. And although the "standard of living" can be a difficult measure to record and compare, real per capita income comes the closest to measuring material well-being. Again, as in the case of all of the above measures, trends in real per capita income closely track, in an inverse fashion, the growth of government intrusion in the industrialized countries.

Table 6 illustrates the changes that have occurred recently in the real per capita incomes of the seven major economies. All comparisons are expressed in terms of an index based on the level of U.S. per capita income. Per capita income in the U.S. is expressed as 100 with the per capita income of the other countries expressed as a percentage of ours. Japan, for example, with an index value of 75.6 for 1984, had in that year a real per capita income equal to 75.6 percent of that of the United States. One other adjustment that has been made is to express the numbers in terms of "purchasing power parity" exchange rates to avoid distortions caused by wide swings in exchange rates. Otherwise, the U.S. lead would be even greater as a result of the dollar's appreciation against other currencies.

TABLE 6
PER CAPITA GROSS DOMESTIC PRODUCT
BASED ON PURCHASING POWER PARITIES
(United States = 100)

Country	1975	1980	1984
United States	100.0	100.0	100.0
Canada	101.8	100.3	95.6
Japan	65.5	71.2	75.6
France	77.5	78.9	75.8
Germany	77.3	81.8	78.5
Italy	60.5	63.7	59.7
United Kingdom	70.2	67.4	65.9

Source: U.S. Bureau of Labor Statistics

With the exception of Japan, which has maintained firm limits on the growth of government spending and taxing, all countries have seen their real per capita incomes fall relative to that of the U.S. Referring back to Tables 1 and 2, there is again a striking correspondence between government growth and economic deterioration. Canada, for example, which matched the U.S. during the 1970s, saw its standard of living slip relative to ours as its government's degree of spending intrusion grew at a rate 65 percent greater than our own during the last twenty years.

Unfortunately, it is not at all clear whether they, or any of the other nations surveyed in this article, have recognized this as a problem yet. Canada, with a conservative government confronting a budget deficit almost twice ours in proportion to its economy, has opted to raise taxes as part of the "solution". In its first budget, the new

Progressive Conservative government proposes a 5 percent surcharge on corporate income tax obligations and a 5 percent to 10 percent surtax on households with income of $40,000 or more. A surtax, of course, is one of the most destructive to economic incentives because it directly raises tax rates.

Although our friends abroad do not seem to fully appreciate the gains attributable to limited government, tax rate reductions and an emphasis on market solutions, there is growing evidence that our own elected representatives from both parties have recognized this and, after some early disenchantment, are now committed to maintaining the goals of the policies enacted in 1981. In the last two months, both the House and Senate enacted separate budget resolutions that entailed spending cuts in excess of $50 billion next year without any increase in taxes. If these spending cuts are ultimately enacted in conjunction with a tax reform package conducive to a strong economy, then the remainder of the decade should see vigorous economic growth for the United States and a further widening of the differences between us and many of the other industrialized countries.

BOOSTING CAPITAL FORMATION AND TAX REVENUES: THE CASE OF CAPITAL GAINS TAX RATE REDUCTION

by
William Orzechowski

Since 1978, we have had a significant reduction of the capital gains tax rate. Over this time period, capital formation, new business ventures, and entrepreneurial activity have received a tremendous boost. New funds raised by venture capital firms have soared and public stock offerings by emerging corporations have exploded. Reductions in the capital gains tax rate have been associated with large increases in the value of corporate equities and in capital gains realizations. As a consequence, over the past five years, capital gains tax revenues have actually increased by almost 50 percent.

The experience with capital gains tax reduction is a clear illustration of the principal axioms of classical economics which maintain that taxation's most important impact is upon incentives. Adam Smith, for example, argued that high marginal tax rates, "obstruct the industry of the people and frequently affords a smaller revenue to the government than what might be drawn from more moderate taxes." Adam Smith's analysis, developed over 200 years ago, continues to be sound advice today. This is especially true in the case of capital gains tax reduction which has been a major spark in the resurgence of the U.S. economy and has led to an increase in tax revenues collected. Hopefully, this lesson will not be wasted on modern day tax reformers, many of whom want to reestablish higher taxes on capital gains.

Capital Gains History

The Revenue Act of 1951 established a maximum tax rate on capital gains of 25 percent that remained in effect until 1969. Most analysts agree that such a favorable rate contributed greatly to the rapid expansion of venture capital and research and development (R&D) activity during those years. Beginning in 1969, through various stages, the 25 percent maximum rate was severely limited and, with the Revenue Act of 1976, was nearly doubled to 49 percent.

In general, the period of rising capital gains tax rates—1969 to 1978—was a period of stagnation for American entrepreneurial activity. Associated with the abrupt rise in the taxation of capital gains was a sharp decline in new funds raised by venture capital firms. As funds for venture capital firms dried up, the development of new and growing companies was nearly stopped in its tracks. This is reflected in the massive decline in new capital raised by emerging companies (see Table 1). The period was crowned with a steady erosion in the value of corporate equities (see Table 2).

TABLE 1
NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS (IPOs) AND VENTURE CAPITAL FORMS

YEAR	NUMBER OF IPOs	IPOs ($ millions)	NEW FUNDS RAISED BY VENTURE CAPITAL COMPANIES ($ millions)
1969	1,026	$ 2,605	$ 171
1970	358	780	97
1971	391	1,655	95
1972	568	2,724	62
1973	100	330	56
1974	15	51	57
1975	15	265	10
1976	34	234	50
1977	40	153	39
1978	45	249	570
1979	81	506	319
1980	237	1,397	900
1981	448	3,215	1,300
1982	222	1,446	1,700
1983	884	12,619	4,100

Explanation: IPOs refer to new capital issued through initial public stock offerings of corporations. This capital flows largely to relatively young and rapidly growing companies.

Source: Going Public: The IPO Reporter (Philadelphia, PA)

TABLE 2
TOTAL MARKET VALUE OF CORPORATE EQUITIES
1959–1982
($ Billions)

Phase I
A Period of Relatively Favorable Tax Treatment for Long-Term Capital Gains

Year	Amount
1959	$ 454.0
1960	451.0
1961	574.0
1962	505.7
1963	597.0
1964	662.1
1965	749.0
1966	682.2
1967	868.2
1968	1032.6

Phase II
A Period of Rising Tax Rates on Individual Capital

Year	Amount
1969	$ 913.9
1970	906.2
1971	1059.2
1972	1197.2
1973	948.1
1974	676.9
1975	892.5
1976	1052.0
1977	991.3

Phase III
Tax Rates on Individual Capital are Progressively Reduced

Year	Amount
1978	$1034.2
1979	1231.3
1980	1635.9
1981	1568.5
1982	1810.2
1983	2150.7

Explanation: The figures for corporate equities – total at market value includes the year-end market value of stocks listed on the New York and American Stock Exchanges, other stock exchanges, an estimate for all stocks traded over-the-counter, and an estimate for closely-held stocks. From this total are subtracted investment company shares, shares of foreign corporations, and intercorporations, and intercorporate holdings. The data are compiled by the Securities and Exchange Commission, (SEC).

Source: Federal Reserve Bank: *Flow of Funds*, Year-end outstanding.

A dramatic shift toward pro-capital formation tax policy occurred in 1978 when members of Congress introduced legislation to reduce the excessive tax rate on capital gains. That year, the maximum capital gains tax rate was cut from 49 percent for individuals to 28 percent.

The 1978 capital gains tax rate reduction was the first of a series of changes which progressively reduced tax rates on individual capital. Other important steps include the reduction in the top rate on investment income from 70 percent to 50 percent, which eliminated the distinction between earned and unearned income, and the 25 percent reduction in marginal income tax rates in 1981-83 which also reduced effective tax rates on capital gains. The top tax rate on individual long-term capital gains has thus been reduced from just under 50 percent to 20 percent.

Early in the 1978 debate to cut capital gains tax rates, skeptics said that such measures would do little for capital formation and would erode government revenues. President Carter argued for an even higher capital gains tax rate stating that the government's tax take would increase further as a result. According to Carter's Treasury Secretary, Michael Blumenthal, "Rolling back capital gains taxation to pre-1969 rates would reduce annual tax revenues by $2.2 billion." However, the actual record shows just the opposite. The capital gains tax rate reduction has meant much more, *not* less, tax revenue, and it has contributed to a significant increase in capital formation in a variety of ways.

Capital Markets

First, since lower tax rates on capital gains increase the rewards for risk taking, it is understandable that those investment activities that involve the most risks would feel the sharpest impact of the change. In fact, the amount dedicated to organized venture capital rebounded from an average of $70 million per year in the years 1969 through 1977 to an average of just under $1.5 billion per year between 1978 and 1983, with total dedications of $1.7 billion in 1982 and $4.1 billion in 1983. This is the nation's seed capital, from which thousands of new companies are started each year.

Second, the favorable effect of capital gains tax rate reduction is clearly seen in the dramatic rise of initial public stock offerings. This source of capital helps finance the development of young and rapidly growing firms. Table 2 illustrates the strangling effect of higher capital gains taxes upon capital formation, as new capital raised through initial public stock offerings (IPOs) crumbled from almost $1 billion in 1969 to a bare trickle of $15 million in 1975. By contrast, after the capital gains reductions began in 1978, there has been a veritable explosion in new capital formation with over $12 billion raised through initial public stock offerings in 1983.

Third, the performance of the equity markets has improved substantially. The nine-year depression in equity values which began in 1969, when tax rates on capital gains were raised, ended early in 1978 when the trend toward lower taxes on capital income began. Since the end of 1977, the value of corporate equities has risen substantially. Other economic factors have most certainly been responsible for some of the increases, including the improved outlook for lower inflation and the prospects for economic growth. Yet, gains throughout 1978-80

took place in spite of worsening inflation and rising interest rates. The common thread throughout the period has been the progressive reduction in tax rates on individual capital. The data for 1980 through 1983 is just as impressive as equity values continued to surge (See Table 1).

Tax Rates and Tax Revenues

In 1978, opponents of lower capital gains taxes argued that the reduction would cost the Treasury over $2 billion in revenue. Voicing Treasury's opposition to the 1978 proposal to reduce capital gains tax rates, Secretary Blumenthal asserted, "The measure would do little for capital formation on its own and would waste revenues." The facts paint a much different picture (See Table 3). Capital gains tax revenues have steadily *increased* even though the maximum tax rate was cut by more than 50 percent.

TABLE 3
TAXES PAID ON CAPITAL GAINS

Year	Capital Gains (billions)	Tax Rate (percent)	Tax Revenue (billions)
1967	$13.7	25.0%	$4.1
1968	18.0	25.0	6.0
1969	14.6	42.5	5.5
1970	9.0	42.5	3.3
1971	13.1	42.5	4.3
1972	17.1	42.5	6.6
1973	16.7	42.5	5.3
1974	13.5	42.5	4.2
1975	14.1	42.5	4.5
1976	18.6	49.0	6.6
1977	20.6	49.0	6.6
1978	23.2	49.0	8.1
1979	28.4	28.0	10.9
1980	29.7	28.0	11.6
1981	30.8	20.0	12.5
1982	34.4	20.0	12.9
1983	45.1	20.0	13.9

Explanation: The tax rate used in the table is the effective maximum tax rate on capital gains above $50,000.

Source: Federal Taxes in Historical Perspective, Office of Economic Research, February 1982, New York Stock Exchange.

The figures on tax revenues are remarkable. When the capital gains tax rate was raised in 1969, tax revenues from capital gains stood at $5.5 billion. However, even though the maximum tax rate had been doubled after 1969, tax revenues averaged only $5.3 billion per year from 1969 to 1978 (the period of high capital gains taxes). In stark contrast, after the capital gains tax rate had been sliced by nearly half in 1978, tax revenues from capital gains averaged $11.1 billion per year. This provides substantial evidence for Adam Smith's dictum that moderate taxation often provides government with more revenues than do higher levels of taxation.

Nonetheless, skeptics continue to question the incentive effects of capital gains tax reduction, arguing that the revenue increases can be explained by "unlocking". This occurs when tax rates are high enough to discourage investors from realizing their capital gains. Decreases in rates would then encourage some investors to realize their capital gains. Tax revenues are then given an "artificial" boost. In this case, revenue increases are hypothesized to be the result of a short-term churning of assets rather than more investment due to better incentives. However, this argument is severely discounted by the long term-rise in realizations and tax revenues that have occurred, suggesting that there exist more powerful forces than short-term unlocking. Moreover, survey data compiled recently by Roger Premus for the Joint Economic Committee indicates that capital gains tax reduction has been the most important factor in the massive rise in capital flowing to venture capital firms. Over 80 percent of the firms surveyed ranked capital gains tax reduction as an extremely important factor in the post-1978 surge in venture capital.

Soaking the Rich

To some, reductions in the capital gains tax rate represent the most persuasive case for tax rate incentives. The argument is simple: lower tax rates on capital gains entice individual investors out of tax shelters, loopholes, and consumption by making taxable investments such as equities, bonds, and plant and machinery more attractive. The results are more production and employment, and greater tax revenues paid by the rich. In the words of Calvin Coolidge, "there is no escaping the fact that when taxation of large incomes is excessive, they tend to disappear."

The evidence thus far indicates that Coolidge was right due to the appearance of greater income reported by wealthy individuals. The so-called "fat cats" are paying more capital gains taxes than ever before. Those with incomes over $100,000 included $11.7 billion of net capital gains in adjusted gross income in 1979, an increase of 72 percent over the $6.8 billion reported for this group in 1978. Since tax reduction was approximately 50 percent for these individuals, the 72 percent increase in reported capital gains means that the tax cuts paid for themselves in upper income brackets, actually generating higher tax revenues. Internal Revenue Service (IRS) data show a similar trend in 1980 as the high-income group reported $12.7 billion in net capital gains.

Likewise, IRS figures for 1982 indicate the same phenomenon. Taxpayers earning more than $75,000 yearly reported a 30 percent surge in capital gains income. This exceeded the reduction in the effective capital gains tax rate that occurred in 1981 when the top rate on investment income was reduced from 70 percent to 50 percent (a reduction of 28 percent). The most spectacular surge in gains occurred in the over $1 million income group who reported an 80 percent increase in capital gains. It is estimated that with the lower rates that were in effect in

1982, U.S. millionaires paid 30 percent *more* taxes than they did in 1981.

Conclusion

The Revenue Act of 1978 ushered in a new era of entrepreneurial activity in the American economy. Skeptics at that time said the 1978 capital gains tax cuts would do little for capital formation and do much to erode government revenues. On both counts they have been proved wrong. Instead of tax revenues falling by almost 25 percent as predicted by Carter Administration officials, the cuts in the capital gains tax rate actually boosted yearly tax revenues by almost double. The 1978 capital gains tax experiment was a success. It is a testament to the power of marginal tax rate reduction in unleashing incentive effects.

GOVERNMENT NUMBERS: CAN YOU TRUST THEM?

by
Martin Lefkowitz

The dismay and consternation surrounding the recently issued first quarter GNP report makes this an appropriate time to examine government data. On May 21, the Department of Commerce announced that the nation's gross national product rose by only 0.7 percent, about one-fifteenth the growth rate registered during the first quarter of last year. Even more disturbing, however, is the size of the revision to the first quarter's growth estimate. The Commerce Department first issued the data for the first quarter of 1985 on March 21, and at that time estimated that growth in the nation's output of goods and services would rise at a 2.1 percent annual rate. One month later the rate of growth was revised down to 1.3 percent. Now, the Department of Commerce reports that growth in the economy was even slower. The current rate of economic growth is one third the estimate issued just two months earlier.

At approximately the same time that the Department of Commerce released the GNP figures, the Department of Labor published data on the employment situation. These data indicated that employment grew at an annual rate of between 3.0 percent and 3.4 percent in the first quarter. (The reason for citing a range rather than an actual employment growth figure is that the Department of Labor uses two employment surveys—the household survey, and the business establishment survey—which yield different results.) As a result, comparing first quarter GNP data from the Department of Commerce to first quarter employment data from the Department of Labor yields conflicting conclusions regarding the economy's health. The data from the Department of Commerce turns the good news, more jobs, into bad news—lower productivity, higher unit labor costs, and higher inflation—since employment growth has been five times higher than the increase in output would warrant.

How Important Are The Government's Numbers?

The data issued by the government serve more than just the purpose of satisfying our idle curiosity. Businesses make billion-dollar decisions based on the assumed accuracy of this information. Americans rely on indices issued by the federal government to dictate changes in contracts, wages and salaries, and the amount of money that is distributed to recipients of Social Security and other government benefits. In addition, federal contracts and federal grants to state and local governments are awarded on the basis of the unemployment rate issued by the Department of Labor. These business decisions, in turn, affect the course of the nation's economy. An expanding economy sends the signal to businesses to gear up, i.e., increase employment and investment, while an economy that is contracting will cause businesses to take defensive action.

The reliance on and acceptance of government statistics as the gospel of economic well-being without any critical evaluation, has placed the economics profession in a position that has, perhaps, allowed economists and government statisticians to play fast and loose with the facts. It might also have given them a credibility that may not be warranted, particularly in view of the shaky ground on which many of the estimates stand, and the frequency with which they are revised.

The wide variation in the estimates of growth indicates that while government statistics may be honest, they may not be accurate or reliable. For instance, a large portion of the GNP data are extrapolations and apportionments from benchmark data which are issued once every five years, rendering the data subject to large errors. In addition, over ten percent of the GNP data are imputations, that is, the placing of a monetary value on goods and services that are not even purchased. For example, the largest imputation in the GNP data is for owner-occupied housing. The Department of Commerce calculates a rental value for the two-thirds of Americans who live in their own homes; this rental value then becomes part of the National Income and Product Accounts. Other such imputations include the value of food, clothing, and lodging given to workers as part of their salaries and wages; food and fuel consumed on farms; and, believe it or not, the value of client services, such as free checking, which many banks provide to depositors who keep a minimum balance in their bank account.

Interestingly enough, according to the Department of Commerce, it is these nonmarket transactions that have been growing faster than the market portion of the GNP. Without taking into account inflation, the market value of GNP increased by 25.6 percent from 1980 to 1983, in-

cluding both goods purchased and the imputed value of goods. However, goods purchased in the market place increased by only 24 percent compared to a 39 percent increase in goods for which a value was imputed.

Errors in measurement and discrepancies between the information distributed by different government agencies affect virtually every economic sector. What follows are some examples of the problems apparent in the data. These affect investment, savings, trade, inflation, and productivity, among other variables.

GNP Data Sending Out Wrong Signals

The major problems relating to data revisions are the changes in the direction of the variables, that is, when initial estimates show a growing economy and subsequent revisions show the opposite. A correct assessment of the direction in which the economy is moving is of paramount importance, since it has a major impact on the development of appropriate government policy. Table 1 presents real GNP data for 1982, showing how misleading government statistics can be. The choice of 1982 is made to prove a point. That was a recession year, and it is during bad economic times that government statistics carry the most weight.

The original data published by the Department of Commerce, would have led policy makers to conclude that, by mid-year, the economy was recovering from recession and that there was no need for corrective action. However, the fourth quarter numbers would have given them cause for concern. The latest revision of 1982 data, published in July 1984, shows that the economy troughed in the third quarter and the fourth quarter was one of recovery.

TABLE 1
QUARTERLY GROWTH IN REAL GNP
(annual rates)

1982 Quarters	Originally Reported	Currently Reported
First quarter	−3.9 %	−4.6 %
Second quarter	+1.7	−0.8
Third quarter	+0.8	−0.9
Fourth quarter	−2.5	+0.5

Source: U.S. Department of Commerce

The $86 Billion Error

The source of much of the discrepancy appearing in the data is not unknown. A confidential memo from the Council of Economic Advisors, reports of which appeared in the national press last month, revealed that the Department of Commerce, the final arbiter of the economy's performance, has ignored price declines in computers. As a result, it has understated the real value of GNP by $86 billion, or almost five percent of the total value of goods and services produced by the U.S. economy. The impact of this change is particularly important during the current period of economic expansion. Correcting the data for this error, shows that the growth rate in 1984 would have been in excess of 3.0 percent compared to 6.8 percent which was actually reported.

More significantly, correcting for this error would increase the amount of investment in producers' durable equipment by 56.7 percent over current estimates. This indicates that the changes in the tax law introduced under the Economic Recovery Tax Act of 1981 (ERTA) had a significantly greater impact than currently estimated. This is the case because the correction would mainly affect the current recovery, which has already resulted in more investment than any previous post-war recovery.

In addition to understating the value of total output, the $86 billion error changes virtually all measures of economic performance including economy-wide productivity, particularly in the manufacturing sector; the value of industrial production; the value of real exports; and, because of the recent increase in consumer demand for computers, real consumer expenditures.

Savings Data Also In Disarray

There also exists a large discrepancy between the measures of savings reported by the Department of Commerce and those reported by the Federal Reserve System. Department of Commerce data on individual savings indicates that consumers saved $156.8 billion in 1984. Federal Reserve data, on the other hand, shows that consumers saved $204.6 billion, a difference of $47.8 billion in total savings, the equivalent of over $500 per household. The significance of this difference is that it may also affect the level of personal income. The Department of Commerce derives its calculation of savings as the difference between total income after taxes and consumer expenditures. The Federal Reserve, however, uses data based on financial assets and liabilities as the basis for arriving at the savings rate. The fact that the Federal Reserve has come to the conclusion that Americans saved 30 percent more last year than the Department of Commerce data would suggest, may indicate that personal income is understated by that amount. Alternatively, it could indicate that consumer spending may be less than the Department of Commerce estimates. Either way it could add up to a $47.8 billion error in calculating total GNP.

Consumer Price Index Outmoded

One of the most closely followed pieces of economic data issued every month is the Consumer Price Index (CPI). Every one percent change in that index costs the government over $2.5 billion in increases in government

benefits that are adjusted for inflation. Over eight million people have jobs whose pay scales are directly linked to the CPI. This index is so widely used that it has become known as the "cost-of-living index."

But is it really a "cost-of-living" index or does it fall short of the mark? The CPI is based on a sample of prices of food, clothing, and other goods and services that consumers buy for day-to-day living. Price changes are measured by re-pricing the same market basket at regular time intervals and comparing its aggregate costs. The index currently in use was revised in 1978 and is based on a Consumer Expenditure Survey undertaken in 1972-73. In January 1983, the Department of Labor changed the way in which home ownership costs are measured, replacing the asset price approach then in use with a rental equivalent.

Unfortunately, this approach does not approximate the real world. Most consumers regularly substitute certain goods and services for others. For instance, if the price of steak rises relative to that of ground beef, consumers will buy more hamburger and less steak. There are, however, other indices which account for this substitution. The Department of Commerce publishes the implicit price deflator for personal consumption expenditures (PCE) which is considered to be a more accurate reflection of changes in the "cost-of-living" since it reflects what consumers are purchasing at the present time rather than what they were purchasing a decade ago.

The data in Table 2 indicate that between 1979 and 1984, the CPI increased by over 59 percent compared to the PCE deflator which rose by 48 percent. The use of the CPI, rather than the PCE, as a basis for cost-of-living increases has resulted in a $20 billion increase in the deficit. The issue of the accuracy of the CPI is underscored by a recent report of the General Accounting Office which stated: "The Bureau of Labor Statistics' quality control...[is]...not sufficient to insure the accuracy of the price data used to construct the CPI...."

TABLE 2
COMPARISON OF CHANGES
IN THE CPI AND PCE DEFLATOR
(selected years)

Year	Percent change		Difference
	PCE	CPI	(CPI–PCE)
1979	9.0	11.3	+2.3
1980	10.2	13.5	+3.3
1981	8.7	10.4	+1.7
1982	5.9	6.1	+0.2
1983	3.7	3.2	−0.5
1984	3.2	4.3	+1.1
1979–84 (Compounded)	48.0	59.3	+11.3

Source: Economic Report of the President, February 1985

Balance of Payments Data: Another $80 Billion Discrepancy

Much has been written about the international balance of payments and the balance of trade problems facing this country, however, few people realize that the data should essentially be used as an indicator of direction rather than as an absolute measure. Based on available data, the world experienced a current account "deficit" of $80 billion in 1982. This, of course, is theoretically impossible since, by definition, one nation's (or group of nations') deficit should be another's surplus. If data collection were completely accurate, the world's current account, that is, the amount of money flowing between countries, should net out to zero.

Of course, the temptation exists to blame statistical discrepancies on other countries since they are assumed to lack the statistical prowess of the U.S. But, guess again! The following quote from a Department of Commerce press release shows that our data collection accuracy is no better than any other country's. The report *Summary of U.S. International Transactions–Fourth Quarter and Year 1984,* states: "The statistical discrepancy–errors and omissions in recorded transactions–was an inflow of $30 billion."

What To Do?

The above are only a few of the data-related problems currently identified. It is not an exhaustive catalog nor is it a list of grievances. It is, however, only the tip of the iceberg.

The question of data improvement and data issuance has become paramount because of the number of decisions, private and public, that are based on the data issued by the federal government. Weakness in our statistical base is an impediment to both government and business decision making. The inaccuracies undermine the decision making process for business researchers, marketing researchers, financial analysts, and business organizations in general. Data collection methods which would, at the same time, yield more timely and accurate statistics, and be unobtrusive and not unnecessarily burdensome to the business community, need to be identified.

It is because of the need for improving the timeliness and accuracy of data both, national and international, that the U.S. Chamber of Commerce is engaging in such a project. The goal of the data improvement project is to improve the accuracy of data collection not only in this country, but worldwide, in order to allow analysts to better interpret the various changes in the global economy which have emerged in the last 40 years.

TRENDS IN COMMERCE
NOTES ON TABLE II
JUNE, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's revised estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the inflation-adjusted growth rate slowed to a seasonally adjusted annual rate of 0.7 percent in the first quarter. This is about one-half the 1.3 percent growth rate estimated in April. The data continues to indicate that the consumer and business sectors increased spending in the first quarter, but much of the increase in demand was met from an 11.3 percent rise in imports rather than from increases in domestic production.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.5 percent in April, the same as in March. The money supply in the latest three-month period has been growing at an 8.6 percent seasonally adjusted annual rate, above the Federal Reserve target range for money growth.

Employment—The civilian unemployment rate remained unchanged at 7.3 percent in May for the fourth month in a row. Civilian employment—as measured by the monthly survey of households—increased by 15,000 persons (seasonally adjusted), to 107.0 million, bringing the employment increase in the last twelve months to nearly two million. In contrast, the number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 345,000 in May. This increase reflects the continued strength of service sector and construction employment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.4 percent in April, following a 0.5 percent rise in March. Over half the April increase was due to increases in gasoline and fuel oil prices. Gasoline prices in April rose 3.1 percent, following a 3.6 percent increase in March, bringing the two month rise in gasoline prices to 6.8 percent. However, prices for food purchased for home consumption declined for the second month in a row.

Wholesale prices of finished goods rose 0.3 percent in April, following a 0.2 percent increase in March. This marks the first back-to-back monthly increases in finished goods prices in over a year. The increase in finished goods prices, at the wholesale level, resulted mainly from one month increases in gasoline prices of 9.5 percent and in the price of home heating oil of 10.2 percent. From April 1984 to April 1985 the finished goods index increased only 0.7 percent.

The more volatile part of the Producer Price Index, crude goods, declined by 1.2 percent in April, following decreases of 1.9 percent and 1.5 percent, respectively, in February and March. Crude materials prices in April were 8.3 percent below their levels of a year ago. Weak crude material prices appear to be a product of the strong dollar, and a surplus of farm products. Crude food and feedstuffs prices have declined nearly 10 percent since the start of the year.

Housing Starts—Privately-owned housing units started in April reached 1,913,000 units (seasonally adjusted annual rate), the best level for any one month in a year. The surge in housing starts was mainly the result of the decline in interest rates which has lowered the cost of home ownership and increased the affordability of new homes. Although new single-family home sales fell by 11.9 percent in April, existing home sales maintained a strong pace, inching up to a three million unit rate.

Industrial Production—Industrial production declined 0.2 percent in April, following three consecutive months of increases. Production decreases were apparent in most major categories of manufactured goods. The only increases registered in April were in defense and space products, and construction supplies. Production of consumer goods fell by 0.4 percent, this was due mainly to a 1.2 percent decline in automotive products and a 0.8 percent decline in home goods. Business equipment production also declined 0.3 percent in April, the fourth consecutive decrease, but remained over eight percent above the level of April 1984.

The capacity utilization rate for manufacturing decreased 0.5 percentage points in April as factories operated at 80.5 percent of capacity. The sectors suffering the largest declines in utilization were electrical machinery and motor vehicles and parts. Manufacturing capacity increased 0.8 percent in the first quarter of 1985, 3.1 percent above the first quarter of 1984.

Productivity—Nonfarm business productivity fell at a 2.5 percent annual rate in the first quarter, compared with a preliminary estimate of 1.2 percent. The decline was the most drastic since the fourth quarter of 1981, when it dropped 4.4 percent. The productivity decline resulted from an increase in jobs of over 800,000 in the first quarter (which amounts to a three percent annual rate of growth in employment), while the economy was growing at a 0.7 percent annual rate. The revision in the productivity number can also be attributed to the downward revision of the GNP data. Output was essentially flat while hours worked by employees increased at an adjusted 3.3 percent rate, the biggest jump since the second quarter of last

year. The combined effect of employees' working longer hours and producing less caused unit prices in the nonfarm sector to soar at an adjusted annual rate of 8.1 percent.

Interest Rates—At ten percent, the prime interest rate is three percentage points below last summer's peak, and at the lowest level since October 1978. The reduction in the prime rate reflected the lower cost of funds to the banks and is not an indicator of future trends in interest rates. Rates fell on all maturities, but the largest decline was in the yield for one-year securities, which fell 30 basis points to 8.02 percent. The cost of short-term funds to the banks, as represented by the federal funds rate and the average interest rate on 90 day Certificates of Deposit, has fallen by between 3.5 and four percent since the summer of 1984, which may indicate that the prime has still further to fall.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that business failures continued to rise in mid-April and were almost four percent above the level of a year ago. The index of business failures, which uses October 1983 as a base of 100, increased to 109.4 in the week ending April 19, 1985, the highest level of 1985. This was eight percent above the business failure index reported a year ago. The business discontinuances index was 18 percent above the year-ago level. The recent rise in business failures is largely the result of an increase in agricultural failures.

The latest available data indicates that there were 583,147 new business incorporations in the first eleven months of 1984, a 6.3 percent increase over the same period in 1983. The continuation of the current trend would result in over 635,000 new business corporations having been formed in 1984, an increase of 35,000 from the previous year. The number of new business corporations formed in November 1984 was 53,490 (seasonally adjusted), 3.6 percent more than the same month a year earlier. New business incorporations increased rapidly in the first six months of 1984, but actually declined in the third quarter. The data for October and November indicate a resumption of growth in the number of new corporations formed in the first two months of the fourth quarter. Seventeen states registered increases of more than 10 percent from their year-ago levels in November, with Louisiana, South Carolina, and Georgia reporting the largest increases.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 19.7 percent in April compared to its year-ago level. In the first seven months of fiscal 1985, federal expenditures increased by 12.2 percent, three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Federal receipts, during the same period, have increased by 13.1 percent as a result of increases in personal income taxes, corporate income taxes and social insurance taxes. Receipts for the month of April were up 17.8 percent from the same month a year ago, partially as a result of a more than 35 percent increase in final settlements for taxes owed for calendar year 1984. The federal government deficit in the first seven months of fiscal 1985 is $118.9 billion, over $10 billion more than in the comparable period of 1984. In addition, delays in mailing out tax refunds will add nearly $6 billion to the deficit because the Treasury must pay interest on refunds processed after June 1st. The continued growth of the deficit, despite the double digit growth of federal receipts, indicates that the deficit is the result of excessive growth in federal outlays rather than the result of tax cuts.

Personal Savings—According to Department of Commerce data, personal savings declined to 4.6 percent of after-tax income in the first quarter of 1985, from 6.2 percent in the fourth quarter of 1984. The reason for the decline in the savings rate appears to be directly related to the delay in mailing out tax refunds, which consumers normally rely on at this time of year. The delays in the refunds reduced after-tax income by $6.7 billion in February and March, which when translated into seasonally adjusted annual rates, amounts to over $40 billion, on average, for each of the two months.

Retail Sales—Sales at the retail level jumped 0.9 percent in April, following a 0.7 percent decline in March. April retail sales were 4.5 percent higher than their year ago level. The big gains were reported by department stores showing a 1.9 percent increase, and auto dealers with an increase of 1.7 percent. In real terms, retail sales are running nearly 5 percent ahead of a year ago.

Trade Deficit—The trade deficit, on a goods and services basis, increased to $73 billion in the first quarter. The deterioration is the result of a $5.8 billion decrease in first quarter exports while imports continued to increase by $11.2 billion. The merchandise trade deficit rose by $800 million in April to $11.9 billion, the largest increase in a year. The increase in the April merchandise trade deficit was the result of a 3.6 percent decrease in the value of exports and a 0.5 percent rise in imports. The April increase in imports was attributed to increases in oil imports and a 25 percent increase in the number of Japanese cars imported following the lifting of the voluntary restraint program on car imports.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, decreased 0.2 percent in April, with six of the ten available indicators down. The decline follows an upwardly revised increase of 0.1 percent in March. The index of coincident indicators, a monthly approximation of aggregate economic activity, rose 0.1 percent in April, following a 0.4 percent gain in March.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Mar/85	238.3	238.1	236.1	0.1	0.9
Gross National Product ($B) [a]	I/85	3,817.1	3,758.7	3,553.3	1.6	7.4
Gross National Product (72$B) [a]	I/85	1,665.4	1,662.4	1,610.9	0.2	3.4
Money Supply (M1) ($B) [a]	Apr/85	575.0	572.1	539.2	0.5	6.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Apr/85	2,446.3	2,449.4	2,310.1	0.7	6.8
Personal Consumption Expenditures (72$B) [a]	Mar/85	1,087.3	1,093.5	1,039.1	−0.6	4.6
Disposable Personal Income ($B) [a]	Apr/85	2,717.2	2,640.6	2,543.5	2.9	6.8
Disposable Personal Income (72$) [a]	Mar/85	1,172.2	1,180.6	1,151.8	−0.7	1.8
Personal Savings Rate (%)	Mar/85	4.6	4.5	6.5	0.1[b]	−1.9[b]
Civilian Employment (millions) [a]	May/85	107.0	106.9	105.2	0.1	1.7
Civilian Unemployment Rate (%) [a]	May/85	7.3	7.3	7.8	0.0[b]	−0.2[b]
Average Hourly Earnings [a]	Apr/85	$8.54	$8.50	$8.25	0.5	3.5
Consumer Price Index (All Urban, 67 = 100)	Apr/85	318.8	317.4	307.4	0.4	3.7
Purchasing Power of the Dollar (67 = $1.00)	Apr/85	0.312	0.313	0.323	−0.4	−3.5
Prime Interest Rate (%) May 31, 1985		10.0	10.5	12.5	−0.5[b]	2.5[b]
Retail Sales ($) [a]	Apr/85	112.2	111.3	107.4	0.9	4.5
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	I/85	224.2	228.7	243.3	−2.0	−7.9
After Tax	I/85	140.0	141.0	150.6	−0.7	−7.0
Industrial Production (67 = 100) [a]	Apr/85	165.4	165.8	162.1	−0.2	2.0
Capacity Utilization Rate (Mfg.) (%)	Apr/85	80.5	81.0	81.3	−0.5[b]	−0.8[b]
New Housing Starts (thou. units) [a]	Apr/85	1,913.0	1,883.0	1,949.0	1.6	−1.8
Net Business Formation (67 = 100)	Apr/85	115.1	115.2	117.5	−0.1	−2.0
New Business Incorporations (Thousands) [a]	Nov/84	53.5	52.6	51.6	1.7	3.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100) [a]	I/85	163.2	160.0	158.3	2.0	3.1
Unit Nonlabor Costs (77 = 100) [a]	I/85	160.9	160.3	152.2	0.4	5.7
Producer Price Indices (67 = 100)						
Crude Materials [a]	Apr/85	307.7	311.5	335.4	−1.2	−8.3
Intermediate Goods [a]	Apr/85	319.1	318.4	320.1	0.2	−0.3
Finished Goods [a]	Apr/85	293.6	292.7	291.6	0.3	0.7
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100) [a]	Apr/85	626.1	594.4	523.0	5.3	19.7
Federal Government Debt Outstanding ($B)	Dec/84	1,667.4	1,635.5	1,415.3	2.0	17.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	I/85	363.5	367.2	358.9	−1.0	1.3
Imports of Goods & Services ($B) [a]	I/85	432.6	423.2	410.4	2.2	5.4
Balance on Goods & Services ($B) [a]	I/85	−69.1	−56.0	−51.5	23.4	34.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100)	Apr/85	167.4	167.7	168.1	−0.2	−0.4

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference